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A FRAMEWORK TO ADDRESS PENSIONS AND RETIREES' HEALTHCARE ON BEHALF OF LOCAL UNITS OF GOVERNMENT THROUGH BONDING

June 17, 2013

BUSINESS ISSUES

Far too many local units of government have committed to fund defined-benefit pension and / or other post-employment benefit (e.g. OPEB as in healthcare, insurance, etc.) programs that they are now unable to fund. Often, these two fringe benefit programs are codified in collective bargaining agreements. Employees and retirees' are expecting benefit payments upon retirement as committed to by the local unit of government.

The City of Detroit's recent proposal restructuring plan, however, may increase the concerns of active employees, terminated vested employees and particularly retirees. Detroit's emergency manager is considering the unfunded actuarial accrued liabilities of the pension and OPEB plans as an unsecured City obligation. Bankruptcy is certainly a possibility with these obligations being restructured. In doing so, the amounts paid to retirees could be significantly altered over the original commitments provided by the City many years ago. This situation, which then has the possibility of being replicated, will heighten government employee and retiree concerns in finding a more palatable solution these benefits.

While most local units of government will fully fund the pension contributions (as required by both the State's Constitution and statutes the absence of which could lead to an emergency manager), the funding of OPEB contributions frequently have included only the *current* retirees' medical and other costs immediately due (often referred to as 'pay-as-you-go' funding method).

Unfortunately, when the local unit of government funds only the pay-as-you-go amount, it has shorted the contribution for the employee rights earned during the year for a benefit to be paid when the employee retires many years into the future. The pay-as-you-go funding method creates fiscal pressures as the retirees' medical benefits (where the retirees are providing no current services to the public) compete with current operating needs of the local unit.

Essentially, retirees' healthcare benefits funded on a pay-as-you-go basis crowd out core services such as police, fire, EMS, and other 'core' services. As retirees' benefits must be paid arising from prior commitments and rights earned, current services frequently suffer. In the most egregious situation, many of these local units of government are now on the State Treasury 'watch list' or are in emergency manager status today and have retirees' healthcare obligations virtually impossible to resolve.

The Michigan Municipal Services Authority (MMSA) or an equivalent organization may be able to assist in mitigating future fiscal distress that could occur by leveraging the recently-passed legislation permitting the issuance of bonds for the unfunded actuarial accrued liabilities for either pension and / or OPEB fringe benefit programs (P.A. 329 or 2012 attached). The bonds would be taxable for federal purposes in accordance with the IRS (even as the Michigan component would be non-taxable) and the present interest rate for a AA bond or better could be between 2.7% and 4.0% over a twenty-year term – far less than the investment income assumption that most pension and OPEB plans in use today (roughly, 7% to 8% or so).

The difference between the bonded debt service paid (e.g. principal and interest) is substantially lower than the assumed rate if investment income returns over the long-term by up to 3.0% to 4.0% (say an investment assumption of 7.5% and an interest rate of 4.0%) and would help to cover future annual required contributions for pension and / or OPEB plans. The bond proceeds deposited into a VEBA trust would benefit the retirees' by providing security and could help mitigate future contributions for the local unit of government as well.

This sizable interest rate differential (in part driven by current historically low rates) affords local units of government a unique opportunity to fix their long-term obligations at a preferential interest rate over a period shorter (often 20-year bonds) than the normal amortization period of a program that would be properly funded in accordance with an actuary's recommendation (normally, a 30-year period). Shortening the funding period helps to reduce the long-term costs of these fringe benefit programs.

GOAL

To assist local units in mitigating the future operating costs associated with pension and / or OPEB benefit programs.

STRUCTURE OF PROPOSAL

A framework for the transaction flows relating to the proposal to assist certain smaller (as yet defined) local units of government in benefitting from Act 329 for bonding of presently unfunded pension and / or OPEB obligations. Obviously, all of the below matters would have to be determined to be legally feasible (if not, a change in legislation would be warranted providing the MMSA or similar unit to consider this proposal further). Intergovernmental agreements would need to be drafted as well. The financial feasibility of each local unit petitioning the MMSA or similar unit would have to be reviewed against policies yet to be drafted concerning financial, legal and other conditions.

A brief description follows as outlined in the attached diagram depicting an OPEB arrangement; a similar approach would be feasible for pensions as well):

- The eligible local unit of government would petition to participate in the MMSA or similar program. The eligibility criteria would have to be defined but it would be for the smaller local units that could not reasonably issue debt as the bond issuance and related costs and program management could negate the 'arbitrage' benefits. Bundling these smaller units into a single debt issue (or periodic series of debt issues) could serve to assist these smaller local units.

- MMSA or similar entity would approve entry into the program and along with several other local units. A bond issue would be developed with one or more local units participating. The bond would be recordable on the local unit's financial statements, but the related pension and / or OPEB obligation would be removed.

  In doing so, the MMSA or similar entity would help local units in minimizing the uncertainty of the pension and / or OPEB obligation being carried locally and should theoretically improve the local unit's credit rating to be used for other projects. Ultimately, State Treasury would have to approve the bond issue involving two or more local units of government.

- The bond proceeds would flow into a Voluntary Employee Benefit Association trust fund (VEBA, either directly or via the MMSA or similar entity). The VEBA would be an irrevocable trust fund whereby the only expenditures permitted would be:

  - Payment of retirees' medical expenses if self-insured or more likely, premiums paid to an insurance company.

  - Administrative expenses paid to the MMSA or similar entity as a service fee for operating the program.

  - A provision for a 'risk pool' as an offset against potential declines in the market during limited periods of time.

- Semi-annually, the local unit would pay the debt service (e.g. bond principal and interest) to the MMSA or similar entity and in turn, the MMSA or similar entity would pay the bondholders.

- Likely, the investment pool would be co-mingled such that the VEBA would be a multiple-employer, cost-sharing program (similar to the Michigan Public Services Employees Retirement System – e.g. schools pension plan). This approach has several advantages, including the elimination of the pension and / or retirees' healthcare obligations from the local unit's books, the exclusion from the State's comprehensive annual financial report (assuming the entity is legally separate) and generally, providing assurances to the retirees the future benefit payments would occur. The investment pool would be managed by an outside vendor (or, could even be annuitized if determined to be feasible).

- In order to secure a minimum AA bond rating (as required under the PA 329 of 2012), the State through an intergovernmental agreement would intercept the local unit's revenue sharing payment (or other funding) as a condition against the local unit's default. While this approach may limit some local units that receive minimal or no revenue sharing, this mechanism would be required to ensure payments to the MMSA or similar entity.

BENEFITS / RISKS / ISSUES TO BE RESOLVED

The benefits would include:

- A single entity would be able to assist smaller local units of government in securing bonded debt that might otherwise be unavailable to them given their operating size, credit rating and other issues. These local units would then be able to avail themselves of the present low bonded interest rates serving to reduce future operating costs associated with these benefit programs.

- The benefits in the MMSA or similar program would minimize the future fringe benefit costs for the following reasons –

    - The investment income (long-term rates of 7% to 8%) should be able to be used, over the debt service payments at rates of under 4%, such that the differential covers the principal payments required, returns a small amount of administrative fee to the MMSA or similar entity and provides security to the retirees' that their future retirement benefits will be honored. (Note – this particular issue would have to be modeled with the assistance of a bond attorney, financial advisor and an actuary using potential local units of government).

    - The current annual required contribution is amortized over a 30-year term today. If the debt period were limited to 20 years, the local unit would avoid paying the financing costs of the last 10 years today – or, longer if they are using a pay-as-you-go funding method.

    - The bond rating agencies should look on this approach as favorable as the local units move a 'soft' liability into a 'hard' liability and solve what is now a 'negative' impact on their local unit's bond rating (particularly when considering the Detroit emergency manager's plan under consideration). Over the past several years, the bond rating agencies have become increasingly concerned with the ability to fund its earned employee commitments in the form of pensions and OPEB benefits by local units.

    - This arrangement could very well help to avoid several local units from entering emergency management. In each of the local units presently under an emergency manager operation, the unfunded actuarially accrued OPEB liabilities are staggering in several fiscally-troubled entities (Detroit - $6.0 billion; Pontiac - $380 million; Flint - $800 million; etc.).

- The multiple-employer employer cost-sharing program would allow smaller local units to spread their risk of adverse healthcare losses over a larger pool.

- The assets held in a VEBA or pension trust likely would be protected from bankruptcy. However, given the likely reduction in Detroit's pension certificates of participation obligation the difficulty in issuing this type of debt may have just increased.

The risks would include:

- The most obvious risk is a reduction in the investment portfolio value such that the amount of benefits to be paid could be jeopardized and could open additional funding requirements of local units beyond the original debt service payments required.

  Potentially, this can be mitigated by periodically addressing the funding of supplemental contributions from the local units (say once every two or three years).

- The program results in a catastrophic loss involving a retiree for health insurance purposes. This particular issue could be resolved through stop loss insurance by claim.

- The 2010 federal health insurance program (e.g. Affordable Healthcare Act) introduces uncertainty of future coverage in this industry. The rules and regulations are currently being drafted for a national healthcare program that launches on January 1, 2014, less than 10 months away. Healthcare covers roughly one-sixth of the gross national product of this country. In addition, the economic increases for healthcare programs have generally exceeded the national consumers' price index in the past.

- The closing of a pension and / or OPEB plan results in a change in the underlying assumptions used by the actuary such that the actuarially- calculated annual required contribution often increases over the short-term. The increase in contribution requirements is temporary and at roughly 6 to 10 years actually would be reduced from levels otherwise funded using an actuary's recommended contribution. However, because the plans would be closed as a condition of the bond issuance, longer term these costs would decline as employees leave, retire or die.

BUSINESS ISSUES

Issues and matters to be determined:

- The legal feasibility of this approach must be researched. If the approach isn't currently feasible perhaps a legislative change is in order.

- The pension and retirees' medical programs would have to reflect a standardized package (or packages) such that the fringe benefit administration would be minimized.

Determining what would be a reasonable package(s) would be initially difficult. The actual program would be administered by a third-party entity depending upon the nature of the fringe benefit program (e.g. self-insured, insured, etc.).

- The Michigan Employee Retirement System operates pension plans on behalf of local units and the relationship to MMSA or similar entity would have to be clearly defined.

- The IRS status of the VEBA trust or pension trust would have to be secured.

- The MMSA or similar entity should secure a bond counsel, financial advisor and an actuary (likely pro bono) to run several 'what if' analyses on potential local units' information during the formation of the program. An informational campaign on the availability of the program would have to be provided along with written material.

- A concern would be that the local unit's new debt service payment would be higher than the appropriated budgeted amount for the pay-as-you-go funding method such that the increase would make the program not feasible, even as it would provide substantial future savings. The financial advisors would have to work with local management to assess the return on investment that a local unit might enjoy from this program.

- The MMSA or similar entity would have to determine the size of the local unit that would be eligible for the program. Entities in emergency manager status would be excluded and those with sizable unfunded pension and / or OPEB obligations likely would have such a weak bond rating that it would be impossible to secure an appropriate interest rate in the issuance of debt.

- As a condition of acceptance, the OPEB program would be closed. PA 329 of 2012 requires pension plans to be closed. The new hires for OPEB would be included in a Health Savings Account (defined contribution) plan. Similarly, the PA 329 of 2012 requires that the local unit open a defined contribution pension plan for new hires for as long as the bond is outstanding.

- An actuary would have to assist in determining the pension or OPEB contributions required, if any, after the bonds are issued. Normal costs (e.g. costs incurred resulting from the active employees earning rights in future benefit programs) would continue after the bond proceeds. Determining the impact on a local unit such that the normal cost and debt service still makes the bond issuance feasible would have to be coordinated between the actuary and bond financial advisor.